

§ 1.162-11 Rentals.

(a) *Acquisition of a leasehold.* If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. For disallowance of deduction for income taxes paid by a lessee corporation pursuant to a lease arrangement with the lessor corporation, see section 110 and the regulations thereunder. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in amortizing the costs incurred after July 28, 1958 of acquiring a lease. See § 1.197-2 for rules governing the amortization of costs to acquire limited interests in section 197 intangibles.

(b) *Improvements by lessee on lessor's property.* (1) The cost to a lessee of erecting buildings or making permanent improvements on property of which he is the lessee is a capital investment, and is not deductible as a business expense. If the estimated useful life in the hands of the taxpayer of the building erected or of the improvements made, determined without regard to the terms of the lease, is longer than the remaining period of the lease, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining in the term of the lease, and such deduction shall be in lieu of a deduction for depreciation. If, on the other hand, the useful life of such buildings or improvements in the hands of the taxpayer is equal to or shorter than the remaining period of the lease, this deduction shall be computed under the provisions of section 167 (relating to depreciation).

(2) If the lessee began improvements on leased property before July 28, 1958, or if the lessee was on such date and at all times thereafter under a binding legal obligation to make such improvements, the matter of spreading the cost of erecting buildings or making perma-

nent improvements over the term of the original lease, together with the renewal period or periods depends upon the facts in the particular case, including the presence or absence of an obligation of renewal and the relationship between the parties. As a general rule, unless the lease has been renewed or the facts show with reasonable certainty that the lease will be renewed, the cost or other basis of the lease, or the cost of improvements shall be spread only over the number of years the lease has to run without taking into account any right of renewal. The provisions of this subparagraph may be illustrated by the following examples:

Example 1. A subsidiary corporation leases land from its parent at a fair rental for a 25-year period. The subsidiary erects on the land valuable factory buildings having an estimated useful life of 50 years. These facts show with reasonable certainty that the lease will be renewed, even though the lease contains no option of renewal. Therefore, the cost of the buildings shall be depreciated over the estimated useful life of the buildings in accordance with section 167 and the regulations thereunder.

Example 2. A retail merchandising corporation leases land at a fair rental from an unrelated lessor for the longest period that the lessor is willing to lease the land (30 years). The lessee erects on the land a department store having an estimated useful life of 40 years. These facts do not show with reasonable certainty that the lease will be renewed. Therefore, the cost of the building shall be spread over the remaining term of the lease. An annual deduction may be made of an amount equal to the cost of the building divided by the number of years remaining in the term of the lease, and such deduction shall be in lieu of a deduction for depreciation.

(3) See section 178 and the regulations thereunder for rules governing the effect to be given renewal options where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make.

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§ 1.162-12 Expenses of farmers.

(a) *Farms engaged in for profit.* A farmer who operates a farm for profit